United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-6070 76-6080 Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

JOSEPH C. WEBER, INC.,

Plaintiff-Appellee-
Cross-Appellant

v.

UNITED STATES OF AMERICA,

Defendant-Appellant-
Cross-Appellee

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ON APPEALS FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK

ANSWERING AND REPLY BRIEF FOR THE UNITED STATES

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STATEMENT OF THE ISSUES PRESENTED

On the taxpayer's cross-appeal:

Whether the District Court correctly refused to direct the entry of a verdict that the payments made by Mobil Oil Company to Joseph C. Weber were earned by Weber individually rather than by the taxpayer, Joseph C. Weber, Inc.

On the Government's appeal:

Whether the record contains evidence capable of supporting the verdict that the payments received by Weber from Mobil Oil Company were then intended as compensation to him from the taxpayer corporation.

SUPPLEMENTARY STATEMENT OF THE CASE

With respect to its appeal, the Government relies on the statement of the case made in its opening brief filed in this Court, and in addition thereto states the following facts relating to taxpayer's appeal:

A stipulation of facts was filed in this case on February 4, 1972. (R. 2.) Less than three months later, on April 28, 1972, the Government filed a motion to amend the stipulation by substituting the word "payment" for the word "commission" throughout the stipulation. (R. 2, 28-29.) On July 26, 1972, the District Court (Judge Henderson) denied this motion, without prejudice to its renewal at trial or to the right of the Government to seek to introduce evidence as to the nature of the payments. (R. 2, 29, 133.) At the outset of the trial, on November 4, 1975, the Government again moved to be permitted to amend the stipulation to substitute the word "payment" for "commission." (R. 28-29.) The District Court (Judge Curtin) denied the motion (R. 40), but declined to rule on whether the stipulation was sufficient to make out a prima facie case for the taxpayer (R. 40). When the Government sought to introduce evidence consisting of copies of credit invoices from the Mobil Oil Company files in order to establish the nature of these payments (R. 119-120, 254-263), taxpayer's counsel objected on the ground that such evidence was being offered to impeach the stipulation (R. 129-131). After hearing arguments by counsel, the District Court overruled the objection, holding that the jury should be permitted to hear

evidence to establish the relationship of Mobil, Joseph C. Weber, and the taxpayer, and to establish the circumstances under which the payments in question were made. (R. 133-134.) Later, when counsel were discussing the questions to be put to the jury, the District Court ruled that, from looking at the stipulation as a whole, it was obvious that the Government, at least, had intended to leave open the question of whether the payments were earned by the taxpayer or Weber individually. (R. 170.) Accordingly, the court ruled that the question of whether the taxpayer or Weber earned the payments should be submitted to the jury, and it was so submitted. (R. 173, 264.)

ARGUMENT

Taxpayer's Cross-Appeal

THE DISTRICT COURT PROPERLY REFUSED TO GRANT A DIRECTED VERDICT IN FAVOR OF THE TAXPAYER, SINCE THE STIPULATION WAS NOT INTENDED TO AND DID NOT PRECLUDE THE GOVERNMENT FROM OFFERING EVIDENCE TO ESTABLISH THE NATURE OF THE PAYMENTS MADE BY MOBIL TO JOSEPH C. WEBER AND SINCE TAXPAYER DOES NOT CONTEST THE FACT THAT THE EVIDENCE PRESENTED BY THE GOVERNMENT WAS SUFFICIENT TO SUSTAIN THE JURY VERDICT.

The taxpayer's argument in support of its contention that it was entitled to a directed verdict is predicated upon its view as to the legal effect to be given a stipulation entered into by the parties during the pretrial proceedings in this case and filed on February 4, 1972. (R. 2, 24-27.) In particular, the taxpayer contends (Br. 3-4) that the use of the word "commission" in the stipulation to characterize the payments in

issue conclusively established both the nature of the payments and the fact that they were taxable to Mr. Weber individually, rather than to the taxpayer. Taxpayer does not affirmatively argue that, as a matter of law, the use of the term "commission" in the stipulation, whether or not a correct legal description of the payments, was absolutely and forever binding and not subject to subsequent correction, even with the approval of the court. Such an argument would be incorrect. See Carnegie Steel Co. v. Cambria Iron Co., 185 U.S. 403, 443-444 (1902). It would be a miscarriage of justice to permit one party to prevail solely on the basis of an initial inadvertent use of a mis-descriptive word in a stipulation when, well prior to trial, the other party makes a good faith effort to correct the matter and when the original erroneous description did not prejudice the right and opportunity of each party to present its case fully at trial. Rather, taxpayer places its entire reliance upon a form of estoppel argument, alleging (Br. 4-5) that it was placed at a disadvantage in preparing its case because the Government sought to repudiate the use of the term "commission" at the trial. Although taxpayer refrains from saying so directly, its argument embodies the implication that it was taken by surprise by this effort of the Government at trial. Nothing could be further from the truth. The taxpayer was informed, more than three years before trial, that the Government did not accept its contentions with respect to the meaning of the word "commission" in the stipulation because the Government

filed a motion on April 28, 1972, to amend the stipulation by eliminating the word "commission" and substituting the word "payment" throughout the stipulation. (R. 2, 28-29.) On July 26, 1972, the District Court denied the Government's motion, but expressly reserved for trial the question of whether the Government was precluded by the stipulation from advancing any particular theory as to the nature of the payments in question. (R. 2, 133.) Thus more than three years before trial, the taxpayer was made aware of the fact that the Government disputed its interpretation of the word "commission" as used in the stipulation and that the question was open for argument and ruling at the trial and that it would probably be raised. The taxpayer had more than ample time in which to prepare its case against the possibility that the Government's position would be accepted and if it failed to do so, it has nobody to blame but itself. Indeed, in view of the lack of legal or equitable justification for taxpayer's effort to take unwarranted advantage of the Government's inadvertency, it could well have expected that the court would not limit the Government's case. Moreover, it is worthy of note that the taxpayer does not actually state that there was other evidence which it might have presented.

We do not understand the intended thrust of taxpayer's comments regarding the Berger testimony (Br. 6-7) or the special allowances (Br. 8). We can only assume that it is a recognition that merely attaching the label of "commissions" to the amounts here in issue (all that could follow from giving the effect

sought by taxpayer to the stipulation) would not establish that they were earned by Weber rather than taxpayer. The Berger testimony quoted by taxpayer suggests that Weber was receiving so-called commissions from Mobil in connection with the sale of oil by the latter to taxpayer. Taxpayer does not suggest how this helps its case. First, taxpayer does not affirmatively contend that the amounts here in issue constituted payments of that nature and offers no proof on that point one way or the other. Taxpayer, of course, as noted in our first brief, fn. 4, p. 11, has the burden of proving all facts on which it relies in seeking refund. But, even if it were so established, it would not help taxpayer since, as a matter of law, such payments by a supplier are deemed to be earned by the corporate principal even though paid to the officer acting for it in making the purchases. In X-L Service, Inc. v. Service, Inc. v. Commissioner, 32 T.C.M. 701 (1973), on facts very similar to those of the present case, the Tax Court rejected an attempt by the controlling shareholder of a gasoline retailer to divert income from the taxpayer corporation by causing its supplier to make certain payments (there characterized as rebates) directly to the shareholder.

The reason for the above rule is obvious. If it were otherwise, any controlling officer and shareholder of a small corporation could shift income at will between himself and the corporation by arranging with the supplier for rebates to be paid directly to the corporation (when he wished the latter to be the reported earner of additional taxable income in the amount in question) or by arranging that they be paid to himself as a commission

(when he prefers to reflect it as his own income). Patently, the supplier who is willing to pay a commission is prepared to make sales on the basis of actual receipt of the net (the billed amount less the commission) and couldn't care less whether, so long as it receives the required net, the difference goes to the corporate managing officer as commissions or to the corporation as a reduction in actual price. Any corporate purchasing officer is obligated to make purchases for the corporation on the basis of the lowest available price. When he makes a purchase at a higher price than that at which the product is available in order to get the difference as a separate commission to himself, and does this with the knowledge and approval of the corporation, it constitutes an intentional diversion to him by the corporation of the additional net profit it would have enjoyed had it required him to purchase for its account at the lower net price at which the purchase could be made. Such diversions constitute either compensation to the corporate purchasing officer if that is what was intended (see the Government's appeal herein), and if it does not exceed reasonable compensation, or it constitutes a constructive dividend if the officer is also a shareholder and if the amount is not affirmatively intended at the time diverted to be paid as compensation. Cf. Federbush v. Commissioner, 325 F. 2d 1 (C.A. 2, 1963).

There is no basis in any of the arguments and comments made by taxpayer for reversal of the jury verdict that the amounts in question were earned by the taxpayer.

Government's Appeal

SINCE THERE WAS NO EVIDENCE TO SUPPORT IT, THE DISTRICT COURT ERRED IN REFUSING TO SET ASIDE THE VERDICT OF THE JURY THAT THE PAYMENTS FROM MOBIL TO WEBER WERE INTENDED BY THE TAXPAYER AS COMPENSATION FOR WEBER'S SERVICES

Our case for reversal of the judgment in favor of the taxpayer rests on the contention that taxpayer failed to meet its burden of proving (Op. Br. 11)[1/] that, at the time the payments in question were received by Joseph Weber, they were intended as payments of compensation from taxpayer to Weber. In its answering brief, taxpayer makes no claim that the stipulation (see our opening brief, pp. 15-17) has any tendency to establish the requisite intent. Indeed, taxpayer makes no assertion that the record contains any affirmative evidence of an intent to pay compensation but attempts to bridge the gap with the contention (Br. 12) that its returns are "consistent" with the fact that the money received by Weber was intended as compensation and not dividends. In support of this, taxpayer points to the 1962 and 1963 returns where, in response to a specific inquiry as to dividends, it had replied that none had been paid.[2/] First, this is no more consistent with an intent to pay compensation than with the contrary. The taxpayer's returns in fact disavow receipt by it of the funds in question and, necessarily therefore, constitute negation of payment thereof to Weber either as dividends or as compensation. The reports in the taxpayer's

1/ "Op. Br." references are to our opening brief as appellant designated "Brief for the United States".

2/ Because, for the reasons to be shown, this claim of evidence is unfounded in any event, we will not concern ourselves with the question whether this would avail the taxpayer with respect to payments in the years 1964 and 1965.

returns of compensation paid to Weber (Pl. Exs. 1, 2, and 3, Schedule E) exclude the amounts here in issue and thus constitute denial of payment of these amounts as compensation to the same extent as the items cited by taxpayer constitute denial of payment of dividends. For this reason, the returns are not consistent with the contention that the amounts were intended to be paid by taxpayer as compensation to Weber and this is no less so because they are also inconsistent with an intent to pay them as dividends.

Moreover, even if it could be said truly that the returns are consistent (in the sense of being not inconsistent) with an intent to pay compensation, this would not supply the necessary affirmative proof required of taxpayer. Assuming, arguendo, that Weber's returns (reflecting receipt of the amounts from Mobil, rather than taxpayer) were not of record and that taxpayer's returns did not contain a statement as to compensation paid by it and that they did not, therefore, reflect (as they do) a denial of payment to Weber of the amounts in question as compensation, we would have only a barren record evidencing no intent to pay either compensation or dividends (and, indeed, disavowing receipt by taxpayer of the amounts in question so as to make either possible). Such a record could not support the jury verdict that the amounts were intended by taxpayer to be paid to Weber as compensation. The mere denial of payment of dividends could not constitute affirmation of payment of compensation in any event and certainly not in the absence of any indication in the returns that the amounts had been first received by taxpayer and then paid out to Weber in some form.

Once it has been established (as the jury found below) that the amounts were earned by taxpayer--not Weber--and that they

must therefore be deemed constructively to have been received by Weber from taxpayer, it remains only to determine whether they are to be treated for tax purposes as constructive receipt of compensation or constructive receipt of dividends. Either one is inconsistent with the tax returns which reflect no such payment to Weber under either classification. The fact that the treatment of the amounts as having been received by Weber from the taxpayer is completely constructive in nature, a rejection of the form in which the taxpayer and Weber sought to cast it, rules out the possibility of treating it as compensation because the latter requires an actual contemporaneous intention that it be paid and received as compensation. On the other hand, as we pointed out in our opening brief (fn. 11, p. 18), treatment of amounts received by a shareholder as a constructive dividend does not require any actual subjective intent to pay a dividend. 1 Mertens, Law of Federal Income Taxation (1974 Rev.), §907; Dawkins v. Commissioner, 238 F. 2d 174, 180 (C.A. 8, 1956). See, DiZenzo v. Commissioner, 348 F. 2d 122, 126-127 (C.A. 2, 1965); Simon v. Commissioner, 248 F. 2d 869, 873 (C.A. 8, 1957); Chesbro v. Commissioner, 21 T.C. 123 (1953), aff'd 225 F. 2d 674 (C.A. 2, 1955), cert. denied 350 U.S. 995 (1956). In fact, a constructive dividend is by its nature in contradiction to the intent of the corporate managers and to the manner in which the amount in question was recorded and reported for tax purposes. Therefore, when amounts which have been treated and regarded as something else by the parties involved in the transaction are held to have been constructively received by the shareholder

from his corporation, they must a fortiori be treated for tax purposes as constructive dividends since treatment as compensation requires an actual evidenced intent to pay them as such (incompatible with the necessity to recast the transaction constructively as a receipt from the corporation) whereas treatment as a payment of dividends results from a construction of the law and without any regard to the intent of the parties. That is the situation here.

CONCLUSION

For the reasons stated, the judgment of the District Court should be reversed with directions to the District Court to enter judgment for the United States notwithstanding the verdict.

Respectfully submitted,

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NOVEMBER, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this answering and reply brief has been made on opposing counsel by mailing four copies thereof on this 4th day of November, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

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